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Tax Forum

Doris L. Bosworth

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TAX FORUM

DORIS L. BOSWORTH, CPA, Editor
Peat, Marwick, Mitchell & Co.
New York, New York



Restoration of Previously Taxed Income

Perhaps the most basic example of the "claim of right" doctrine is the taxability of interest credited to a depositor's savings account. Even though the individual does not avail himself of the amount so credited, he has an unrestricted right to its use and must, therefore, report it as income. While the rationale of this simple illustration is readily understood, there are many instances where extenuating circumstances can precipitate a problem.

This month the Forum will discuss one phase of the doctrine that has caused much confusion in the past—the tax treatment of amounts which have been reported as income and subsequently restored.

Liquidating Distributions

A common example of this type of transaction is a liquidating distribution of a corporation reported as a capital gain, and subsequently restored in whole or in part, upon settlement of *post* liquidating claims. This may be distinguished from a liquidation distribution at a time when there are known liabilities which the stockholder agrees to pay, or is legally obligated to pay, at some future date.

In the latter case only amounts received in excess of these liabilities are reported as a taxable distribution; and, upon subsequent settlement, any difference may be reflected in an amended return or through the filing of a claim for refund.

Restoration Problem

Where it becomes necessary to restore previously reported income, it is taken as a deduction in the year paid. A problem arises when, due to a difference in the amount and/or composition of income or change in rates, the deduction in the current year does not adequately compensate for the tax impact of inclusion in a prior year.

Where the amount to be repaid exceeds \$3,000.00 it may be possible to obtain relief under Section 1341 of the Code. Under this section taxpayer may reduce his tax for the

year of repayment by the amount of the prior year's tax attributable to the inclusion of income in that year, and any excess tax will be refunded.

Application Perils

Due to the mitigating provisions of this section, it must be stringently applied. In the case of limited applicability under the special rules of Section 1341(b) no problem is presented; but the general rule under 1341(a) has been responsible for a great many cases dealing with the propriety of utilizing this section in a given set of circumstances.

Actually 1341 may only be invoked where taxpayer *appears* to have an unrestricted right to the income, and it later develops that such is not the case. The word 'appears,' as interpreted by the Courts in the past, has not been too comprehensive. A recent ruling, however, should be helpful in future determinations.

Rev. Rul. 68-153, I.R.B. 1968-14, 21 dealt with four situations where previously reported income had been restored by the taxpayer, and advice sought as to the applicability of Section 1341. In the first situation certain shipments were billed subject to refunds in later years when wartime restrictions were lifted. The second restoration resulted from overcharges to customers due to arithmetic errors, which could have been corrected in the year reported if the errors had been recognized. The third situation called for repayment to customers of prior freight charges due to a retroactive change in rate by a regulatory body; and the fourth series of refunds arose as the result of subsequent acts, such as passenger ticket refunds or reduced rates on through shipments. The Service ruled that in the second and fourth examples, where mere errors in computation and specific subsequent events were responsible for the refunds, Section 1341 did not apply. In the first and third situations, however, taxpayer had a "semblance" of an unrestricted right which could not be established to the contrary in fact or in law until a subsequent period, and 1341 did apply. While the results of this ruling could be more or less anticipated from the fact situations involved, it

is notable for its discussion of the word 'appears.'

The connotation attributable to this word is illustrated by the rather extreme example previously discussed in Rev. Rul. 65-254, CB 1965-2, 50. It was pointed out that although income from embezzlement must be included in taxable income, subsequent restoration would not come within the purview of Section 1341, as no semblance of right to these funds could ever rest with the taxpayer. When this current ruling is read in conjunction with cases within this area the applicability of Section 1341 should be clarified.

Executive Compensation—Repayments

No discussion of the restoration of previously reported income is complete without consideration of litigation involving executives in closely held corporations. Upon examination of the corporate tax return a portion of executive compensation may be disallowed on the grounds that it is excessive. Similarly certain reimbursed travel and entertainment expenses may be disallowed due to failure to comply with the regulations. Such adjustments have the effect of double taxation, as the corporation's income is increased and the recipient has either included the payment in income or will be forced to, in the case of reimbursed travel and entertainment expense.

To alleviate this situation many executives have repaid such items to the corporation and attempted to take the deduction in the year of payment, to no avail. It has been the contention of the Service that 1341 did not apply because, at the time of receipt, the executive had the unrestricted right to the use of the funds; and it was only by virtue of a subsequent Treasury Department examination that this status was altered. Lack of business purpose or legal obligation to repay precluded any other justification for the deduction.

A recent decision, Vincent E. Oswald, 49 T.C. 68, offers a possible solution. In this case the corporation adopted by-laws which required all officers to repay any amounts received that were subsequently disallowed as an expense to the corporation, upon examination of the returns by the Treasury Department.

When, six years later, a portion of Mr. Oswald's salary was deemed excessive by the Service, counsel advised him that the by-laws had created an enforceable claim for restitution of the amount disallowed. Accordingly, Oswald restored the salary to the Corporation and took the payment on his income tax return for that year. The Tax Court allowed the deduction on the ground that the payment was a legal obligation and there was a valid

business purpose involved, namely, making funds available to the corporation with which to pay the tax deficiency.

An analysis of the Court's reasoning in this case indicates that where repayment clauses are incorporated in the by-laws or employment contract, and the executive is put on notice of his legal obligation of repayment it will be possible to deduct such payments. This contractual obligation must, however, be created at the outset of the employment contract, as in the past the Courts have disallowed the deduction where a post-examination agreement was involved.

SYSTEMS SERVICES

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accounts, the framework for any accounting system.

Several other activities were preformed by less than half of the firms—and by larger firms more often than smaller offices. These activities include the selection of data processing equipment, the formulation of cost or savings estimates, and the preparation of computer programs. Only 3 per cent of the one-man firms had performed all of the eleven services discussed, while 75 per cent of the largest firms had done so.

Payroll, inventory control, purchasing, and selling-order processing-accounts receivable were the four functional areas in which the accountants had experienced the most frequent demands for systems work.

Many of the differences which existed between the systems services rendered by the larger and the smaller accounting firms resulted from the natures of their respective clients rather than from the inherent natures of the services needed. The systems clients of the larger accounting offices were more often large enterprises with volumes of data to be processed, interrelated, and analyzed, requiring that the consulting group be familiar with the capabilities and applications of complex, multi-faceted systems installations. The clients of the smaller accounting firms often had similar systems problems, but the requirements for sophisticated equipment configurations and the considerations necessitated by complex organizational structures were absent.

Future Expectations of CPAs in the Systems Area

Sixty-eight per cent of the CPAs in this study expected the demand for systems services to accelerate. The remaining 32 per cent anticipated that demand would remain at its present

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